INDEX

	PAGE
Opinions Below	1
Jurisdiction	2
Question Presented	2
Statute and Regulations Involved	2
Statement	3
ARGUMENT:	
The respondents meet all the elements contained in Article 105, Regulations 74 of the Revenue Act of 1928	5
The controlling authorities in the lower Court uphold the respondents' contention that they are dealers in securities	9
Albert Fried & Company were entitled to inventory their securities since they regularly inventoried unsold securities on hand at market, and in its income tax returns for 1929, 1930 as well as 1931, computed its net income at market prices	11
Conclusion	12

TABLE OF CASES CITED

Commissioner v. Charavay, Circuit Court of Appeals, Third Circuit, 79 F. (2d) 406 9

Commissioner v. Stevens, 78 F. (2d) 713 ..... 6, 9, 12

Estate of Harry E. R. Hall v. Commissioner, 29 B. T. A. 1255 ..... 9, 12

Harriman v. Commissioner, 43 Fed. (2d) 950 10

Schafer v. Helvering, 83 F. (2d) 317 ..... 9, 11

Seeley v. Commissioner, 77 Fed. (2nd) 323 11

Vaughan v. Commissioner, decided August 10, 1936 7, 9

PAGE

Revenue Act of 1928, c. 852, 45 Stat. 791 2

Treasury Regulations 74, Article 105 2

MISCELLANEOUS

Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, made on June 20, 1936, Pursuant to Section 11 (e) of the Securities Exchange Act of 1934, page 25 ..... 5, 7

Security Exchange Act (see Section 11, Item b) 8

Webster's New International Dictionary 6

IN THE

Supreme Court of the United States

OCTOBER TERM, 1936

NOS. 186, 187

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ALBERT FRIED

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BENJAMIN EINHORN

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

Opinions Below

The opinion of the United States Board of Tax Appeals (R. 19-23) is reported in 31 B. T. A. 638. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 29-31) is reported in 83 Fed. (2nd) 193.

Jurisdiction

The judgments of the Circuit Court of Appeals were entered April 13, 1936. The cases were consolidated and involve the same question and the same facts. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented

Whether the partnership of Albert Fried & Co. was a dealer in securities in which it specialized, under Article 105, Regulations 74, and as such entitled to inventory such securities at market value in determining net income (R. 14).

Statute and Regulations Involved

Revenue Act of 1928, c. 852, 45 Stat. 791:

Sec. 22. GROSS INCOME.

* * * * * * * * *

(c) Inventories—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * * * * * *

Treasury Regulations 74:

ART. 105. Inventories by dealers in securities—A dealer in securities, who in his books of account regularly inventories unsold securities on hand either

(a) At cost;

(b) At cost or market, whichever is lower; or

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the methods employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years unless another be authorized by the Commissioner. For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities are not dealers in securities within the meaning of this rule.

Statement

All of the facts were stipulated (R. 13-17).

The respondents are members of the partnership firm of Albert Fried & Co. Each of the partners owned a membership on the New York Stock Exchange, where floor space was leased for the transaction of the firm's business. The firm also maintained an office at 120 Broadway in New York City (R. 14).

The firm was a specialist in thirteen stocks traded in on the exchange. It always had on hand the securities in which it specialized, and during the fiscal year ending January 31, 1931, the year involved here, its supply ranged from 10,300

shares at the end of the month to 62,300 shares at the end of another (R. 14-15).

The firm held itself out generally and was known to all of the members of the exchange as the specialist in these thirteen stocks, and it was regularly and consistently engaged in the purchase and resale of such securities (R. 14-15).

Its customers were other members of the Exchange acting for themselves or as brokers, and during the taxable year the firm sold its specialties to 431 of these members and the sales ran from a minimum of 100 shares to a maximum of 5,700 shares. All the stocks which the firm bought and sold were actually received and delivered by it (R. 15).

Sales of the firm were not occasional but were regular, frequent and substantial in amount (R. 15).

For the year under review the firm sold 1,762,100 shares of the thirteen stocks in which it specialized amounting to $125,232,632.36 (R. 15).

Ever since its inception (in accordance with the practice of the New York Stock Exchange and the respondents interpretation of the rulings of the Commissioner of Internal Revenue) the firm has regularly inventoried in its books of account its unsold securities on hand at market value, and in its income tax returns it has computed its net income on the same basis (R. 15), and paid its tax on such basis, and notwithstanding said fact in the year 1931 the Commissioner for the first time denied their right to inventory their stock as a dealer in securities, and accordingly asserted deficiencies against the respondents (R. 6-7; 11-12).

The Board of Tax Appeals by a divided vote approved the Commissioner's action (R. 23) but the Circuit Court of Appeals for the Second Circuit reversed the Board, remanding the cases for further proceedings in accordance with its opinion (R. 29-31).

ARGUMENT

The respondents meet all the elements contained in Article 105, Regulations 74 of the Revenue Act of 1928.

If the respondents meet the requirements set forth by the Commissioner of Internal Revenue in his regulations under Article 105, the respondents must be classified as dealers in securities and have the right to inventory their securities under Section 22 of the Revenue Act of 1928. The respondents contend that they meet each and every one of the requirements set forth in Article 105, as follows:

(a) They have an established place of business.

(b) They are regularly engaged in the purchase of securities and their resale to customers.

(c) * * * That is one who as a merchant, buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. * * *

(a) *They have an established place of business.*

The established place of business is the post at which the respondents are stationed on the floor of the New York Stock Exchange, for the purpose of buying and selling securities in which they specialize, and for which they pay a rental of $2,000 a year.

> "9. The firm leased space on the floor of the Exchange where it transacted its business in the thirteen stocks in which it specialized. The annual rental for this space is $2,000.00" (R. 14).

To this post all brokers wishing to buy or sell the securities in which the respondents specialize come.[1] In addition to

---

[1]In contrast to other members of the exchange who move about freely, the specialist is stationed at a fixed post on the trading premises. (From Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, made on June 20, 1936, Pursuant to Section 11 (e) of the Securities Exchange Act of 1934, page 25.)

the post on the floor of the Exchange the respondents have an office at 120 Broadway, New York City, where the receipts and deliveries of the stocks purchased and sold are made.

(b) *They are regularly engaged in the purchase of securities and their resale to customers.*

The stipulated facts admit that the respondents were regularly and consistently engaged in the purchase and resale of the securities in which they specialize (R. 14).

The customers of the respondents were the other members of the New York Stock Exchange, acting for themselves or acting as brokers for the general public (R. 16).

Commissioner v. *Stevens*, 78 F. (2d) 713.

"Another broker may well be considered a customer. Indeed, unless the firm was a dealer in securities, members of the Stock Exchange who purchased securities from it and who were its customers, could have bought the stock in the open market instead of buying from them."

(c) * * * *That is one who as a merchant, buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom.* * * *

The respondents were merchants dealing in the securities in which they specialized.

"The term 'merchant' * * * includes 'any one making a business of buying and selling commodities,' 'a trafficker,' 'trader' or 'one who trafficks on a large scale.'" Webster's New International Dictionary.

A specialist on the New York Stock Exchange functions both as a broker and as a dealer.

Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, made on June 20, 1936, Pursuant to Section 11 (e) of the Securities Exchange Act of 1934, page 25, item 4 (a) gives the function of the specialist as follows:

> "a. Functions of the Specialist.
>
> The specialist characteristically combines the functions of broker and dealer. As a broker he effects transactions for the account of other members and their customers in a particular stock or group of stocks in which he is registered as a specialist. As a dealer he effects transactions for his own account in such stock or stocks. In contrast to other members of the exchange who move about freely, the specialist is stationed at a fixed post on the trading premises. Every stock dealt in on the New York Stock Exchange has at least 1 specialist; stocks which enjoy considerable trading activity have as many as 6 competing specialists; and some specialists handle as many as 50 stocks.
>
> The specialists occupy the pivotal position in the market for the stocks in which they specialize. As buyers and sellers for their own account or as agents in the execution of orders for others, specialists actually purchase and sell a substantial percentage of all stock traded in on the exchange and actually participate in a great majority of all trades. Even with respect to those transactions in which they are not parties, their bids and offers serve as standards for the appraisal of the market by others."

The Circuit Court of Appeals for the Second Circuit in *Vaughan* v. *Commissioner,* decided August 10, 1936, not yet reported, defined a specialist as follows:

> "A specialist is one who, having a position at a designated 'post' on the floor of the Exchange, maintains a book in which he enters all offers and bids for the stocks in which he specializes, thus indicating the 'market' for the stocks. The offers and bids are ordinarily made by other members of the Exchange. But the specialist is required to be ready at the demand of other brokers to

quote the market price and to buy and sell at the closest fluctuations possible. Where the 'bid' and 'asked' prices furnished by the brokers coincide and the transaction is thereby effected, the specialist acts as a broker in the transaction. But where there is too wide a 'spread' between the 'bid' and 'asked' prices, in order to create a market, he either buys or sells the stock for his own account. Thus he becomes the owner of any stock acquired in this way."

The dealer function of the specialist is definitely recognized in the Security Exchange Act (see Section 11, Item b).

"If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market."

The respondents were admittedly specialists of the New York Stock Exchange (R. 14).

"5. The firm is a specialist in the following thirteen stocks traded in on the Exchange:

Northern Pacific Railway, common stock.
Air Reduction Co., common stock.
United Carbon Co., common stock.
American Zinc & Lead Smelting & Refining Co., common stock.
American Zinc & Lead Smelting & Refining Co., preferred stock.
Davega Stores Co., common stock.
A. Hollander & Sons, common stock.
Minnesota Moline Power Implement Co., common stock.
Minnesota Moline Power Implement Co., preferred stock.
Poor & Co. common stock.
Sterling Securities Co., A stock.
Sterling Securities Co., preference preferred.
Sterling Securities Co., convertible preferred.

To further illustrate that the respondents were merchants we refer to the stipulation of facts (R. 15) wherein it is conceded that the firm had an established place of business and always had on hand the securities in which it specialized and carried from 10,300 shares at the end of one month to 62,300 shares at the end of another month, and that it traded in 1,762,100 shares of the thirteen stocks in which it specialized, the selling price of these shares amounting to $125,232,632.36.

The controlling authorities in the lower Court uphold the respondents' contention that they are dealers in securities.

The respondents rely upon the decisions in *Estate of Harry E. R. Hall* v. *Commissioner,* 29 B. T. A. 1255. *Commissioner* v. *Stevens,* Circuit Court of Appeals, Second Circuit, 78 F. (2d) 713, *Commissioner* v. *Charavay,* Circuit Court of Appeals, Third Circuit, 79 F. (2d) 406, *Vaughan* v. *Commissioner,* Circuit Court of Appeals, Second Circuit, decided August 10, 1936, not yet reported.

In each of the above authorities the courts below have held that a specialist on the floor of the New York Stock Exchange was a dealer and as such entitled to inventory his securities.

The only case in apparent conflict with the above authorities is *Schafer* v. *Helvering,* 83 F. (2d) 317, in which the Circuit Court of Appeals for the District of Columbia held that the taxpayer was a speculator and not a dealer in securities.

The transactions in the Schafer case, however, involved purchase and sales of securities *other than those in which that firm specialized.*

In the instant case, as in the Stevens, Charavay and Vaughan cases, the purchase and sales by the respondents' firm *were of securities in which it specialized.* This dis-

tinction is specifically admitted by the Government in petitioner's brief (p. 7).

> "The transactions of the Schafer Brothers firm, however, involved purchases of securities other than those in which it specialized. These securities were held by it for resale at a profit upon an anticipated or hoped for rise of the market. Such purchases and sales, we believe, were mere speculations and did not serve to classify that firm as a merchant. On the other hand, in the instant case, the purchases and sales of the respondents' firm were of securities in which it specialized."

As was said in the Stevens case:

> "The dealings of the respondent's firm may not be said to be speculative only. The firm held at all times large blocks of stock which it sold in small lots to its various customers numbering at least one hundred, at different times, and it sold at different prices. It bought additional blocks of stock with which to replenish its supply. At all times it had shares of the stock to be sold for profit or loss, as the case may be, on resale. This was its wares or stock in trade * * * The record discloses that the firm bought in these taxable years the stocks of fourteen different corporations, as referred to, for its own account, as distinguished from its purchaser's account, all their purchases were intended for resale at a profit."

This is the exact situation in the instant case, and the Circuit Court so found.

> "We can find no material difference whatever between that case (Commissioner v. Stevens) and this. Following our decision in the Stevens Case, we feel bound to hold that the petitioners have shown themselves to be within the scope of the above-quoted regulation and entitled to the use they made of inventories" (R. 30, 31).

In *Harriman* v. *Commissioner,* 43 Fed. (2d) 950, the Court held that the Harriman National Bank was a dealer

as to the securities bought and sold for its own account for which it maintained a separate department.

The Government in that case attempted to draw inference, as in the instant case, from the testimony and the exhibits, that the real purpose of the bank in purchasing securities was for investment and not for resale. The Court below, however, refused to accept this contention and held the Bank to be a dealer in securities.

On the other hand in all the cases we have been able to find where the taxpayer was denied classification as a dealer the facts indicated that the taxpayer was not a specialist and was engaged in trading on his own account and not as part of a general business in securities.

Another case wherein the dealer classification was denied was *Seeley* v. *Commissioner,* 77 Fed. (2nd) 323.

Seeley had no established place of business, he had no customers, he never bought securities as a stock in trade to be sold thereafter to customers; he was merely a floor trader for a firm of which he was not even a member, and when he bought securities he did not buy for himself, he bought for the firm's customers, and when he sold he did not sell to those customers, but for them.

Albert Fried & Company were entitled to inventory their securities since they regularly inventoried unsold securities on hand at market, and in its income tax returns for 1929, 1930 as well as 1931, computed its net income at market prices.

This question is treated in great detail in the brief submitted by petitioner in the case of *Schafer* v. *Helvering,* Nos. 24, 25 and 26 (pp. 25-29) and respondents do not desire to burden the court with a repetition of the same arguments.

We accordingly submit that the record establishes that Albert Fried & Company has met the burden of proving that it had

(1) An established place of business.

(2) It was regularly engaged in the purchase of securities and their resale to customers.

(3) It was in fact a merchant of securities and like any merchant bought such securities and sold them to customers with a view to the gains and profits that may be derived therefrom.

and the Commissioner's action in denying them the use of inventories was not only erroneous but plainly arbitrary.

The Commissioner's action in this case is purely arbitrary in view of the decision in the *Hall* case where the Commissioner's refusal to classify a specialist as a dealer was reversed by the Board of Tax Appeals and the action of the Board of Tax Appeals was upheld by the Circuit Court of Appeals in *Commissioner* v. *Stevens*. The Circuit Court of Appeals further in the instant case held that there was no material difference between this case and the *Stevens* case.

CONCLUSION

It is respectfully submitted that the firm of Albert Fried & Company was a dealer in securities within the purview of the statutes and regulations and entitled to the use of inventories and that the decision of the Circuit Court of Appeals for the Second Circuit is correct and should be affirmed.

Respectfully submitted,

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